

BOOK REVIEWS

REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES. Part V. Protective Committees and Agencies for Holders of Defaulted Foreign Governmental Bonds. Washington, 1937. 833 p.

The experience of American investors in foreign bonds has been brief but instructive. Of the five billions of the dollar bonds of foreign governments floated in the United States between 1920 and 1931, almost a third, mainly of Latin-American countries, is in total or partial default. Unfortunately, among the Latin-American countries the default ratio is approximately 76 per cent. These bonds are said to have been in the hands of nearly 700,000 investors.

The effort to establish how this misfortune occurred and what measures have been taken or can be taken to protect the interests of the bondholders, engaged the attention of the Securities and Exchange Commission, which under the direction of the Protective Committee Study, headed by Commissioner William O. Douglas, has submitted to Congress an exhaustive report presenting some of the testimony, the findings, and the conclusions and recommendations of the Commission. Considering the peculiar difficulty of the task, the number of people that had to be examined, and the intricacy of the subjectmatter, the results achieved deserve the highest commendation. The systematic presentation of so vast a body of material in an intelligible form and the perspicacity and practicality with which the investigation was pursued, reflect credit on the investigators.

The Committee confined itself in the main to investigating the fate, from origination to default and subsequent effort at rehabilitation, of the recent bond issues of Chile, Colombia, Cuba, Salvador, Peru and Guatemala. The private protective committees for the bondholders which were organized by private *entrepreneurs*, lawyers or issuing bankers receive central attention, for it is the abuses incidental to such committees which lead the Commission to its recommendations for reform. The investigators undertook to examine not only the operations of the private protective committees but the experiences of the successful British Council of Foreign Bondholders, organized in 1868. That led them into a detailed examination of the short experience of the recently organized (American) Foreign Bondholders Protective Council, which, the Com-

mittee finally concludes, after considering several alternatives, constitutes the best protection for the American bondholder. The Committee also heard disinterested experts familiar with the law and practice of rescuing and readjusting foreign bond defaults. They also considered the functions of the Department of State in case of a foreign default and how that interest, in the light of all its implications, might most appropriately be manifested.

Thus the Committee took into consideration all aspects of the problem, public and private, with a view to recommending an elimination of the evils disclosed, better protection for the legitimate interests of the bondholder and the limitation of the responsibility of the Department of State.

The investigators soon established that the legal remedies of the holder of a defaulted foreign bond either in the country of issue or in the creditor or debtor country, are trifling, and that even governmental assistance in the form of economic sanctions or armed force is hardly feasible.¹ Even diplomatic representation is as a rule limited to the employment of good offices for private adjustments, for the Government of the creditors is hardly in a position to intervene actively in the negotiation of a settlement or readjustment. That happens only when political interests are at stake. The readjustment thus as a rule comes down to a negotiation between private creditors and public debtors in which the debtor Government has at stake the restoration of its reputation for probity, its good faith, and the necessity of maintaining its credit for future needs, whereas the creditor has at stake the formulation of a plan which will assure him the best possible return consistent with the capacity of the debtor country to pay. A foreign governmental default and a domestic bankruptcy thus differ in material respects, for in spite of protective clauses, which the investigators do not examine at length, the creditor cannot obtain or distribute the assets of his debtor, but must accept the fact that the debtor country must be given full opportunity to continue to function and that it is to his interest to restore the debtor to the best possible financial condition in order that he may be in a position to discharge the readjusted obligation.

The British experience naturally impresses the Commission strongly. The Council of the Corporation of Foreign Bondholders, with but little governmental support, has earned a high reputation for disinterested service to both creditor and debtor which deservedly may be

¹ In the Dexter and Carpenter case (p. 14) while the Court could not issue a writ of execution against Sweden, the Department of State did recover, diplomatically, \$150,000. Press Releases, No. 210, p. 199.

emulated by the youthful American Council. The British Corporation, organized under Act of Parliament, consists of twenty-one members appointed in part by the British Bankers Association, by the London Chamber of Commerce, and by the Council of the Corporation. Those appointed by the Council, nine in number, must be bona fide holders of foreign bonds to the amount of £5,000. The British organization is fortunate in having capital assets of its own of nearly £200,000. It is financed by the income from these funds and by fees paid by defaulting governments on reorganization and, on occasion, by assisted bondholders. The American Council came into operation only after it was found that the government Corporation of Foreign Security Holders projected by Title II of the Securities Act of 1933, could not be effectively brought into operation because, presumably, it would have been too closely associated with the federal government. In the original plan the R. F. C. was to finance it by a loan of \$75,000. The Department of State, deciding that private persons had better organize the Protective Council, invited the organizing members to meet under its auspices, whereupon a private corporation was formed with directors, officers, an executive committee, and contributors. The fact that these contributors were in large part banks of issue, of whose disinterestedness the Commission is not convinced, has led to the recommendations, to be mentioned below, of a different method of financial support. The American Council has as yet no capital assets.

The principal result of the investigation was to expose the inadequacies of the bondholders' protection through the privately promoted or self-constituted protective committee. Here, especially in the Salvador, Cuban, and Chilean loans, the investigators disclosed a number of evils common to this form of organization. Such committees have certain defensible motives in that they do furnish an opportunity for a common front and explore the possibilities not merely of settlements with the defaulting country but of law suits for misrepresentation against the issuing bankers of the loan. While the investigators appreciated the importance of the private committees' interest and usefulness in holding issuing bankers to their legal responsibilities, they do not have a high opinion of the negotiating powers of such self-constituted or independent committees and point out various weaknesses which tend materially to limit their value. Among these are the following: that the motive of personal profit seems to predominate among at least some of the self-constituted protective committees and that their methods of forcing the bondholder to accept the results of their work and to pay fees even beyond those originally represented are subject to grave criticism. The

investigators note the custom of using prominent names for decoration and the zealotry of lawyers and issuing bankers to obtain control of such committees, not always with an exclusive eye to the benefit of the bondholder. In the latter respect the investigators conclude that the Foreign Bondholders Protective Council, even when sponsoring the organization of protective committees, as in the case of Cuba and Chile, is better equipped to protect the interests of the bondholder.

The investigators deal at some length with the methods employed by private protective committees, such as publicity, solicitation of deposits on a commission basis, and pressure devices on the bondholder. The evils of competing committees for the same defaults are pointed out. Only in the case of El Salvador, where the protective committee's expenses and demands on the bondholder were deemed excessive,² is there a detailed presentation of the morphology of a bond default from original issue to readjustment, the finality of which can rarely be definitely predicted.

Considerable space is given to the role of the Department of State in the process—its actual role in extending its good offices to encourage a private settlement, and what might be its policy in cooperation with the Foreign Bondholders Protective Council so as to relieve the Department of administrative and political burdens as between the bondholder and the defaulting country.

In the ordinary default based on good faith and inability to pay, the Department's role, conforming in this respect with international law, is necessarily minor and mostly negative. Military intervention or economic sanctions are out of the question. In its policy toward Santo Domingo, Haiti and Nicaragua, the Department's interest had to be more active, not for the sake of the bondholders but because at least in Santo Domingo and Nicaragua, financially impecunious administrations had to be helped on their feet, and American bankers were solicited to aid the embarrassed country. Necessarily in such cases the Department had to assume a larger share of responsibility for the correct use of the money loaned and for assuring some degree of reliability in the methods agreed upon for liquidation of the debt. It is in connection with cases of bad faith or in consenting to arbitrate differences that the Department's role becomes more prominent. Where in bad faith there is a diversion of pledged revenues, as in Guatemala, or there is discrimination between American and foreign bondholders, as in the recent case of Germany, the Department is likely to display more active intervention and is justified therein by legal precedents.

² Cf. the Salvador committees practices, p. 345.

The investigators discovered the relative weakness of some of the supposed protective clauses in bonds which one of the attorneys who writes such bonds frankly conceded to be "boiler plate." A covenant to devote special revenues to the discharge of a loan is no more compulsory than the original agreement to service the loan and repay it. But the actual experience with bond issues does not lead to the conclusion that security clauses are without value. They have often served on reorganization to obtain priority for the bondholders particularly affected, as in the case of Egypt, Turkey, Greece, Morocco, Santo Domingo and Mexico. A readjustment has sometimes worked out as planned and at other times has not. Where countries are exposed to political upheavals and the administration is unstable, the value of a promise to pay is necessarily somewhat under par. Perhaps the rate of interest that issuing bankers exact from borrowing countries is as accurate an index as any other of the probabilities of an uninterrupted discharge of the obligation. Pledges of revenues have not much value unless the agents of the creditors are actually placed by the borrowing country in a position to receive and distribute the revenues and enjoy the protection of the creditor government in preventing any modification of the arrangement by the debtor. In this connection it must also be observed that the defaults of recent years, as the investigators point out, are due in part to a general depreciation of the obligation of contract, to the example of the large-scale defaults of the war loans by some of the most powerful governments, and after 1931, to the difficulties of transfer. Indeed, a considerable number of the defaulters of recent years have been able to make their payments in local currency, but because of trade and exchange deterioration have been unable to transfer local currency into creditors' currency.

The investigators take occasion to challenge debtor countries such as Chile and Guatemala for practices inimical to the legitimate interests of the bondholders. The unilateral plans presented by Chile and Guatemala met with the disapproval of the investigators as they did of the bondholders, as inadequate offers not commensurate with the debtor's ability to pay. The Committee is critical of the advantage taken by defaulting governments in failing to supply funds for the discharge of interest while employing such funds to repatriate the depreciated bonds at the low prices which the default itself has brought about. The Committee is also critical of the fact that short-term creditors are able to obtain for themselves a priority over the long-term bondholders, as in the case of Chile, because these creditors are in a position to deny the defaulting country the funds for current needs. The advantage is thus

due to a preferential bargaining position rather than to any legal priority. In this connection as in others the Committee emphasizes the necessity of avoiding conflicts of interest among creditor's and debtor's representatives and among creditors, and for that reason criticizes a law firm which drew the bond contract, presumably in the interests of bankers and bondholders, and then on default represented the defaulting government. They also object to short-term creditors representing in any way the long-term bondholders, for their interests are conflicting.

In a final section appraising existing agencies for the protection of bondholders, the Committee assesses the respective advantages and disadvantages of banker protective committees, independent committees, and the Foreign Bondholders Protective Council. The advantages of the Council are the savings in cost, the advantage of centralization and continuity, the friendly relations with and cooperation of the Department of State, the ability to exercise a degree of statesmanship by taking into account the interests of the defaulting country as well as of the bondholders, and its opportunity to relieve the Department of State of responsibilities which it either should not have or has been compelled to assume for lack of other agency. The Committee agrees that the original public protective corporation planned under the Securities Act of 1933 was too closely identified with the Government for the best interests of all concerned. To be sure, the experience of the Council is as yet too short to be conclusive, for some of its principal activities have been confined to negotiating transfers and preventing discriminations against American bondholders. In complicated cases, as in Cuba, the Council sponsored the organization of a committee largely to forestall a private protective committee.

The Committee deals also with the criticisms that have been made of the Council, for example, that it has failed to take prompt action, that its plan of readjustment was not good, that it has failed to cooperate with independent committees, that it does not legally represent the bondholders, and that its financing brings about closer affiliation with issuing bankers and short-term creditors than objective disinterestedness would require. Only the last criticism is seriously supported by the investigating committee, while admitting that to a limited extent on occasion other criticisms may have been justified. The Committee opposed figureheads acting as directors of the Council. It discountenances affiliation of the Council with issuing bankers or fiscal agents. At all times, the Committee is concerned to have the Council serve "as a disinterested agency free from entangling alliances with those who would pervert the readjustment process to their own ends."

On the whole, however, the Committee concludes that the Council is the best protector for the bondholders and that while it cannot well enforce the bondholders' claims against bankers for rescission and fraud, this function can readily be performed by privately organized committees if they so desire; that there is therefore still a place left for such private committees, which must now register with the S. E. C. The Council failed, the Committee finds, to take aggressive steps to prevent the preferential treatment of short-term creditors in the Chilean and Colombian defaults, and feels that the private committees may aid in insuring that such preference is not accorded. The preference however is due to economic advantage, and is not easy to prevent by admonition. The Council's inability to prevent the Chilean and Colombian preference was, the committee finds, due to inadequate facilities and resources. It is in this connection that the Committee makes its principal recommendation to the effect that the Council should be strengthened and that its resources should be augmented. It suggests capital funds for the Council either from a private foundation or as a loan from the Government. Just on what grounds a private foundation should finance an economic agency created for the protection of bondholders is not readily perceived. The Council could only repay loans to the Government by obtaining fees from the defaulting government, as is the British practice, or from the bondholders. There seems no reason why in this way the Council should not be able to acquire that financial independence which the Committee considers indispensable to the most efficient performance of its functions. It suggests a reorganization of the administration of the Council by dropping figureheads and centralizing responsibility in a small committee with consultants to be approached as occasion requires. Representation by houses of issue, fiscal agents, or short-term creditors on the Council is strenuously opposed. Measures are recommended to curb the repatriation of foreign bonds by debtor countries.

On July 22, 1937, a Board of Visitors was established by the Secretary of State and the Chairman of the S. E. C. to inspect from time to time the Foreign Bondholders Protective Council and to examine its internal financial operations, its expenses and disbursements, including requests by the Council for fees from foreign countries and from American bondholders in connection with debt readjustments, as well as other sources of income.

The Report as a whole constitutes a valuable exposure of certain evils which have accrued in connection with foreign bond financing and reorganization and a constructive recommendation of certain necessary improvements in the practice. The Report cannot fail to have its effects

in diminishing the evils of the private protective committee, while yet affording it a certain sphere of activity. It will probably also strengthen the power and prestige of the Foreign Bondholders Protective Council, for it brings into the open all the factors and influences which tend both to weaken and to strengthen that body. Whether further legislation will be required to bring about greater S. E. C. control of private protective committees or to carry into effect some of the other recommendations of the Committee remains to be seen. At all events, the holders of defaulted foreign bonds should henceforth enjoy better and cheaper protection than they have had heretofore.

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FUNDAMENTAL PRINCIPLES OF THE SOCIOLOGY OF LAW. By EUGEN EHRLICH. Cambridge: HARVARD UNIVERSITY PRESS, 1936. pp. xxxvi, 541.

When this book first appeared in 1912 the phrase "living law" suggested a concept that would overturn the foundations of our jurisprudence, but the world went on after its publication in its erratic way with its war and post-war problems. The translation into English after twenty-five years revives the memories of its first appearance and suggests a reconsideration of the author's theories.

Briefly, the thesis is that "The whole economic and social order of the human race is based upon the following small number of facts: usage, domination, possession, disposition (usually by contract or by testamentary disposition)." (p. 118.) The law is to be found not in the statutes (except for state law in the narrow sense, taxation, administration, etc.) nor for the most part in the judicial decisions which represent the exceptional and often the bizarre case but in the rules which people actually observe, actually live under and live by. This law is to be found in the legal documents people employ and above all in the direct observation of life, commerce, custom, usages, associations.

To range states of fact under established legal concepts is a fatal error. This is the juristic mathematics of concepts. "A playground for bloodless abstractions that scarcely touch the earth with their toes." The author points out, however, that the system of concepts is not in practice as ridiculous as its statement would make it seem, for the legal propositions are created by jurists preponderantly on the basis of norms found in the judgment of courts and when applied as the legal propositions of the Roman law were applied to a state of society vastly different, unconsciously the existing state of society was included in the legal prop-